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Bank of Canada Easing Is Consistent with Its Pursuit of Price Stability

by

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Governor Crow's speech last Thursday did not signal an end to the Bank of Canada's battle against inflation. Recent declines in interest rates are the result of a weaker economy and falling inflation. This easing is appropriate: to make further progress toward stable prices, while avoiding a severe slump, the Bank should aim for low, positive growth in the money supply in coming months.

Did Bank of Canada Governor John Crow's acknowledgement last week that inflationary pressure in Canada is declining signal an abandonment of the quest for price stability?

A consensus — supported by the 135 basis point decline in the Bank Rate since its peak in May — seems to be growing that the Bank of Canada has shifted to an easier stance. But it is rash to conclude, as many headline writers seem to have done, that the Bank has abandoned its fight for lower inflation — a fight which we support. Recent declines in interest rates and the Canadian dollar appear rather to reflect the fact that the Bank's pursuit of price stability is at last beginning to pay off.

In our view, the statement in Governor Crow's speech most worthy of attention was his observation that "the thrust of monetary policy over an extended period of time is probably best seen in terms of its influence over the pace of monetary expansion in the economy." It cannot be overemphasized that continued progress toward price stability depends, as it always has, on the Bank's control of the growth of the money supply.

What implications does this prescription have for Bank policy in coming months? To begin with, monetary policy works with time lags: up to a year to affect real output, and perhaps another year to influence inflation. In 1986–87, the Bank's policies were lax, and money growth accelerated. The inflationary pressures which peaked toward the end of 1989 were the inevitable consequence.

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The Bank began to tighten up in 1988, and became increasingly restrictive through 1989. By the end of 1989, it had brought the rate of growth of M1 — a narrow definition of the money supply, including currency in circulation and non-interest bearing chequing accounts — into a range compatible with the elimination of inflation.

With the money supply expanding more slowly than the momentum of spending in the economy, a growing liquidity shortage drove up interest rates, particularly at the short end, and the Canadian dollar rose with them. The lagged effects of this tighter policy are now becoming evident. The momentum of spending has slowed — real output is down and inflation is falling. As a result, the liquidity shortage has eased, reflected in declining interest rates and a weakening dollar.

At this point, however, it is important to remember that money is created through the extention and redeposit of credit in the financial system. If the money supply is to grow at the modest rate required to maintain price stability — say 3 percent for M1 and 5 percent for the broader money aggregate, M2 — the private sector has to be induced to expand its borrowing from the banks at an appropriate pace. And private-sector demand for credit depends on the outlook for business.

If a potential borrower expects a 20 percent return on an investment, 15 percent is cheap credit. For a business expecting an 8 percent return, however, even 10 percent is cripplingly expensive. Profit expectations have dropped rapidly since the beginning of this year. If, as we suspect, they fell faster than interest rates, then monetary policy was getting tighter even as interest rates fell.

That would explain why money growth rates dropped precipitously this year: the private sector has slowed down its borrowing. By July, M1 had been shrinking at an annual rate of over 17 percent over the previous three months. Fortunately, however — perhaps because the Bank noticed the danger — there was a considerable recovery in August.

Even so, M1 — which tends to lead changes in total spending in the economy — fell at an annual rate of 11 percent in the six months to August, while M2 — which tends to move coincidently with total spending — grew less than 3 percent over the same period. The latter figure confirms that spending growth has slowed down this year; the former warns that it will slow further through early 1991 unless recent falls in interest rates, and those which are likely to come in the next few months, are big enough to bring a few borrowers back to the banks.

In order to stay on course, the Bank must prevent private sector responses to a slowing economy from generating a downward spiral. It can do this by not resisting downward market pressures on interest rates and the exchange rate. The sign that monetary policy is still on track for price stability will be a recovery of M1 growth to a low positive range over the next few months.

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